OLC 75-1849/a

CENTRAL INTELLIGENCE AGENCY

WASHINGTON, D.C. 20505

4 SEP 1975

Mr. James M. Frey
Assistant Director for Legislative
Reference
Office of Management and Budget
Washington, D. C. 20503

Dear Mr. Frey:

This is in response to your request for our views on the proposed repeal of Section 912 of the Internal Revenue Code which excludes from gross income certain allowances paid to civilian employees of the Federal Government serving overseas. We fully endorse the views expressed by Secretary of State Kissinger in his 12 July 1975 letter to Mr. Lynn.

This Agency is strongly opposed to repeal of Section 912 for the following reasons:

1. The overseas allowances in question do not represent additional compensation. They are intended to, and do in fact, defray necessary additional expenses incurred because of overseas service. As Secretary Kissinger points out in his letter, the Overseas Differential Act of 1960 (P.L. 86-707) which authorizes most of the allowances in question, and the House and Senate Reports on that Act, clearly reflect congressional recognition that service abroad entails expenses to employees above those which the employee would incur if stationed in the United States. The tax law has long distinguished between those allowances which represent increments to income (such as the "hardship differential") and those intended to reimburse employees for expenses incurred because of assignment overseas by the Government. These latter non-compensatory allowances include the "cost-of-living" allowance, the housing allowance, and the educational allowance. Increments to salary have traditionally been taxed. Reimbursement for extraordinary job related expenses which do not leave the employee "better off" financially have not been taxed.

(a) Cost of Living Allowance -- This allowance offsets the difference between the cost-of-living at an expensive foreign post of assignment and the cost at Washington, D. C., leaving the employee no worse, but also no better-off than had he

remained in the United States. It simply makes the employee "whole." There is no gain in it for the employee. Taxing this differential would be inconsistent with the basic concepts which underlie the tax laws. It would be unrealistic to expect, and unjust to require, employees to pay additional taxes because prices in those parts of the world to which they are sent by their Government are higher than at home. The foreign relations business of the nation should not be conducted at the personal expense of its civil servants.

(b) Educational Allowance -- All U.S. citizens in the United States are entitled to free public education, financed by Federal, state, and local tax dollars. A Federal employee overseas must normally pay to educate his children. Where he must, the Federal Government pays him an allowance which merely compensates for this extra cost. Taxation of this allowance would mean an employee would not be fully reimbursed for this extraordinary cost, which he incurs solely because of his overseas assignment. Moreover, all employees overseas continue to pay state income taxes. The taxes of these employees continue to help finance the public school system. Taxation of this allowance, which in effect provides them the free education which their taxes support, would mean an unjust double taxation.

For those employees overseas whose states of residence do not require them to pay taxes during their absence, the saving in state taxes does not normally affect overseas educational costs. Free public education is financed by taxes paid throughout the life of the taxpayer, not only while their children are attending public school. The portion of this temporarily reduced tax liability which could appropriately be allocated as an offset to extraordinary educational expenses would be not only minimal, but also impossible to establish equitably.

(c) Housing Allowance -- This allowance is designed to offset against extraordinary housing expenses which an employee encounters as a direct result of his assignment in a foreign country. In many less developed areas of the world where the Government -- unlike business -- must maintain a substantial presence, the only alternative to grossly substandard housing is expensive housing which is very costly for lower level employees. This is reflected in the fact that most employees are expected to, and do in fact, supplement their housing allowance out-of-pocket.

An argument can be made that an employee may be somewhat better-off financially than his counterpart in the United States since he does not pay the basic housing costs he would incur living in the United States. This Agency has carefully studied this question and has concluded that while this may be true in some cases it is by no means the general rule. We found that the existence of "added compensation" in the housing allowance is at best uncertain, and if present, modest; that it would not be possible to develop a methodology to fairly quantify the compensatory value over the broad range of affected employees; and that other "hidden" costs and disadvantages which confront employees moving and living overseas offset whatever profit may be realized from the housing allowance. These "hidden" costs and disadvantages are substantial and include such costs as foregone housing investment opportunities, repair costs on rented property, and the expenses associated with changing one's residence every two or three years. (E.g. General weight limitations make it impractical simply to ship entire households from one place to another and, therefore, it is necessary to dispose of some property which still has value and to replace it at the next location.) It should be noted in this connection that the pattern of overseas rotation and assignment is such that the expenses of transplanting a household are assumed with greater frequency by Government employees than by private sector employees.

If after the Inter-Agency Committee on Allowances and Benefits completes its current review of Federal civilian overseas allowances and benefits, it is determined that there is an element of profit in the quarters allowance as it is now administered, we would endorse Secretary Kissinger's proposal to re-factor the allowance to eliminate that portion which is judged to be additional compensation. This would be preferable to taxing the whole allowance of all affected employees.

2. Repeal of Section 912 would not produce revenue but would in fact result in a net loss to the Government. It has been widely recognized that allowances would have to be increased to offset the taxes to be levied if Section 912 were repealed. In addition, there would be a substantial increase in the workload of simply recording payments in Government records, to say nothing of the increased burden of the employee/taxpayer in submitting his return and of the Internal Revenue Service in processing it. Disbursements which are now charged to expense at the overseas post would thereafter have to be transferred to headquarters for a centralized control and ultimate inclusion in the tax withholding report provided to the

taxpayer and to the Internal Revenue Service. The slight increase in revenue would not balance the cost of larger appropriations for allowances, in addition to the cost of non-productive recordkeeping at the field installation, at headquarters, in Internal Revenue Service, and on the part of the taxpayer. We would have a situation where the tax collection system would have become an end in itself, and the Federal Government would be forced to pay more for conducting its business overseas.

3. It has been suggested that taxation of these allowances is necessary to put employees of the Federal Government on an equal footing with employees of the private sector overseas. This rationale may satisfy an abstract sense of symmetry, but it rests on false premises. All Americans overseas are not, in fact, in a comparable economic condition. Overseas Americans fall into three distinct groups which have little in common other than their citizenship. These groups -- the military, the civilian services, and private business interests -- are present overseas for entirely different purposes and they live under different circumstances. Their taxation should be based on the specific position of each group.

The civilian services are present overseas to represent the foreign affairs interests of the country. This presence must be maintained in virtually all areas and countries of the world regardless of the relative costs and risks involved and without reference to the quality of economic, political or social life in different localities. The services performed produce no revenue, and the costs are controlled through appropriations. The private business presence, however, is intended only to produce profit for those who sponsor it. The presence is maintained as long as the profits are high enough to justify it; benefits to the private employee can be escalated to almost any level as long as they are below the revenues which are produced, and the cost of allowances designed to offset the extraordinary overseas living expenses of employees are usually deductible as business expenses by private corporations. When profits fall below an acceptable level, the presence is simply ended. In areas where business prospects are poor, a costly presence need not be established.

The motivation and objectives are different for each sector; compensation and incentive are also different. We know of no overseas corporation which limits their salary levels to Government pay scales. For example, a recent contract between an international American airline and a pilots' union provides for compensation as high as $80,000 per annum. It is clear that private business interests are willing to establish compensation levels well above those of the U.S. Government. Economic reality is that these two overseas populations -- private sector employees and the civilian service -- are not in the same economic position. Government tax policy should not be based on an assumption that they are. Consequently, sections 911

and 912 of the Internal Revenue Code should be considered separately, and if section 912 is to be modified it should be on the basis of facts and not attributed to "equity" with the business community.

It should also be noted that corporations, in sending U.S. citizens abroad, normally concentrate on managerial and executive personnel. For middle level staffing, and even some managerial positions, they use local nationals who do not have to be paid allowances and salaries based on U.S. pay scales. The Government civilian services, and especially the intelligence services, cannot use foreign nationals to represent their interests. The trend toward the use of foreign nationals by corporations is being accelerated by the current economic problems, and the disparity between overseas corporate benefits and those of Government employees can be expected to widen.

The benefits and tax considerations concerning military personnel are also entirely unlike those of either the civilian services or the private business community. Except for the relatively small number of military personnel affiliated with the embassies, military forces overseas have salary structures established by Congress on the basis of their unique requirements, they operate in an entirely different environment, and are subject to entirely different control by the Congress. In many cases their presence is controlled by separate treaties which are, of course, subject to Senate approval. We defer to the DOD in the assessment of its own situation and the proposed changes, but we are convinced that the circumstances of military service are so dissimilar to those of foreign civilian life that major Government policies should not be established on the assumption that they are alike. U.S. Government policies with respect to overseas representation must make a distinction between civilians living in a foreign community and military units stationed in U.S. military bases abroad.

In sum, it is our view that consideration of any change in the present tax treatment of allowances should await completion of the current inter-agency review of overseas allowances and benefits and that a flat repeal of Section 912 at this time would be inequitable, prejudicial to the operations of the foreign affairs agencies, potentially inflationary, and without benefit to overall U.S. Government operations.

If there are inequities in the current practices, they tend to be between individuals receiving allowances who have different economic requirements rather than between Government employees and others. If there are occasional windfalls to individuals, they are matched by shortfalls

to those employees who are not adequately compensated for accepting overseas assignments. These are the expected faults in any general system with broad application. They do not in any way detract from the basic character of the allowances which is to provide an advantage to the Government, by making it possible to send well qualified personnel overseas with adequate support to perform their functions.

Sincerely,

SIGNED

STAT [redacted]

Legislative Counsel

Distribution:
Orig - Addressee
1 - DDA
1 - DDO
1 - OP
1 - OF
1 - Compt
✔ - OLC Subject, w/basic
1 - OMB Liaison
1 - OLC Chrono
OLC: WPB: sk (3 Sep 75)

EXECUTIVE OFFICE OF THE PRESIDENT

OFFICE OF MANAGEMENT AND BUDGET

WASHINGTON, D.C. 20503

August 1, 1975

LEGISLATIVE REFERRAL MEMORANDUM

To: Legislative Liaison Officer

Department of Agriculture
Department of Commerce
Department of Defense
Department of Health, Education, and Welfare
Department of the Interior
Department of Justice
Department of Labor
Department of Transportation
Department of the Treasury

ACTION
Agency for International Development
Energy Research & Development Administration
Central Intelligence Agency
Civil Service Commission
General Services Administration
Veterans Administration
U.S. Information Agency

Subject: State Department views on taxation of overseas allowances of Federal civilian employees, as proposed in H.R. 17488, 93rd Congress, "Energy Tax and Individual Relief Act of 1974," with particular reference to (1) the difference if any, for tax purposes, between American private sector and Federal civilian employees working overseas; and (2) the elimination of elements of additional compensation reflected in quarters and other allowances currently paid Federal overseas employees.

The Office of Management and Budget would appreciate receiving the views of your agency on the above subject before advising on its relationship to the program of the President, in accordance with Budget Circular A-19.

(X) To permit expeditious handling, it is requested that your reply be made within 30 days.

Questions should be referred to Hilda Schreiber (395-4650) or to Ralph N. Malvik (395-4702), the legislative analyst in this office.

Naomi R Sweeney

Naomi R. Sweeney, for
Assistant Director for
Legislative Reference

Enclosures

THE SECRETARY OF STATE

WASHINGTON

July 12, 1975

Dear Jim:

The Ways and Means Committee is considering that portion of the "Energy Tax and Individual Relief Act of 1974" dealing with foreign income. I have heard that the Administration is scheduled to testify before the Committee in early July.

One provision of the proposed legislation might be the taxation of allowances paid to government civilians serving overseas. This is of great concern to me since taxation of overseas allowances would have serious implications not only for the Department of State, but for all other government agencies with civilian employees serving abroad. If we are to retain the flexibility we need in the personnel administration of our overseas operation, we must insure that our personnel are not financially disadvantaged through the taxation of allowances which represent reimbursement to them for the unusual costs associated with their overseas assignments. Such allowances cannot and should not be considered incremental income to employees.

The Overseas Differential Act of 1960 (P.L. 86-707) which authorizes most of the overseas allowances in question, and the House and Senate Reports on that Act, clearly show Congressional recognition that service abroad entails expenses to employees above those which the employees would incur were they stationed in the United States. There has never been any intention to give overseas employees advantages over their colleagues who serve at home, but rather to treat them equally. I know that many misconceptions exist, both in and out of government, as to the true nature of overseas allowances and benefits. Where unbalanced treatment exists, I believe we are well on the way to correcting it and reestablishing a firm and clearly justified basis for the allowance program. I do not think these imbalances in application of law or regulation justify treating allowances as incremental income, however.

The Honorable
James T. Lynn,
Director,
Office of Management and Budget.

An Inter-Agency Committee on Allowances and Benefits is currently reviewing the existing structure of federal civilian overseas allowances and benefits to arrive at recommendations on a comprehensive allowance program which would, effectively and equitably, meet current requirements for overseas operations.

Since the treatment of allowances for tax purposes is an essential element of the entire allowance structure, all committee members were asked to comment on the proposed repeal of Section 912 of the Internal Revenue Code. There was general agreement that consideration of any change in the present tax treatment of allowances should await completion of the current inter-agency review, and that a flat repeal of Section 912 at this time would be grossly inequitable, prejudicial to the operations of foreign affairs agencies, and without significant benefits to overall U.S. Government operations.

I think a brief review of some of the more significant overseas allowances will show why it would be inappropriate to subject them to taxation. The essential feature of each of these allowances is that it is intended to defray necessary additional expenses incurred because of overseas service. With the exception of the hardship differential paid to employees at unhealthy, dangerous or otherwise less desirable posts, which is currently subject to taxation, none of the allowances are classified as "premium" allowances.

-- The cost-of-living allowance is simply an equalizer designed to offset the difference between the cost of living at an expensive foreign post of assignment and in Washington, D.C. It is not realistic to expect employees to pay additional taxes because prices are higher in some parts of the world. For example, the cost of living for U.S. Government civilian employees in Geneva is 54% higher than Washington; in Kuwait 30% higher; in Yaounde 46% higher; and in Caracas 14% higher.

-- An education allowance is authorized so that all parents employed by the Government overseas can provide their children with the level of education which is available to all children free in the United States. Clearly this is not incremental income and not properly taxable.

-- The quarters allowance is also an offset against extraordinary housing expenses which an employee encounters as a direct result of his assignment in a foreign country. The average yearly cost of rent and utilities for a typical government employee between 1974 and 1975 rose by $1,974 in Copenhagen, $314 in Ankara, $2,075 in Beirut, $1,953 in Geneva, $596 in Lima, and $114 in Bangkok. With shortages of adequate housing and spiralling rent and utility costs at most foreign locations, the quarters allowance continues to be necessary to assign the right person to the right post at the right time.

I recognize that there are differences of opinion as to whether this last allowance includes an element of additional compensation and if so, whether it is justifiable. In my opinion if an employee overseas is advantaged by this allowance we should examine the method of computing the allowance and attempt to correct it rather than act precipitously to tax the quarters allowance. In this connection I am confident that the Inter-Agency Committee composed of senior officers from twenty government agencies will thoroughly study the problems and recommend remedies designed to achieve the results that we all seek.

It has been suggested that it is necessary to tax the allowances of government civilians overseas because we want to treat them in the same manner as employees of private industry overseas. I do not believe that repeal of Section 912 will contribute toward equal treatment, when the conditions under which each group serves are vastly different in so many ways. No more should we suggest that taxation of military allowances and benefits would constitute equal treatment for civilian and military personnel. It must be recognized that we are dealing with three vastly different groups with different reasons for being overseas, needs and responsibilities. That fact alone argues for the need for separate treatment and different procedures to meet the specific needs of each group.

For all these reasons, I believe that the Administration's position before the Ways and Means Committee should be to recommend that allowances not be taxed, and that correction of deficiencies in the program be left to the Administration through the Inter-Agency Committee on Overseas Allowances and

Benefits for U.S. Employees which would keep the Congress informed of the progress of its work. I am sending a similar letter to Bill Simon expressing my thoughts on this subject. I hope that both of you will agree with my very strong recommendations regarding the Administration's position on this issue.

Warm regards,

Henry A. Kissinger